‘NOT TRANSPARENT’: THE COURT OF APPEAL’S DECISION ON THE DELAWARE LLC IN *HMRC V ANSON*[1]

By Marika Lemos

INTRODUCTION

Earlier this year,[2] the Court of Appeal – upholding the decision of Mann J in the Upper Tribunal[3] – decided that a Delaware Limited Liability Company (LLC) known as HarbourVest LLC (HV) was not ‘transparent’ for UK income tax purposes. This is in accordance with guidance published by the UK tax authority, Her Majesty’s Revenue & Customs (HMRC), but contrary to the decision of the First-tier Tribunal (FTT).[4]

The profits of HV, attributed to Mr. George Anson under the relevant US federal and state law, had been subject to US tax in his hands (at 45%). During the relevant period, Mr. Anson was resident in the UK, and the profits of HV were received by him in the UK. The consequence for Mr. Anson of the Court of Appeal’s finding is that the distributions from HV received by him while he was resident in the UK were not the ‘same profits or income by reference to which the United States tax’ was computed (within the meaning of the relevant double tax conventions): Mr. Anson was subject to UK income tax on those profits at 22% and was not entitled to double tax relief. Therefore, the profits of HV were subject to an effective tax rate of 67%.

Analysis

The decision of the Court of Appeal in *Anson* is not surprising, but it is in some important respects unsatisfactory: in particular because the risk of economic double-taxation of taxpayers is not mitigated by any greater certainty as to how foreign entities should be classified for UK tax purposes. This article examines the impact of the decision on the question of entity classification.

When does the need for entity classification arise?

When the legal systems of the UK are confronted with, for example, a business organisation of a character which they do not themselves have, the question that arises for UK tax purposes, is whether the organisation should be characterised as a company, a partnership or a trust.[5]

An entity which is recognised by one or other of the legal systems of the UK as a partnership is fiscally 'transparent' for all UK taxes: it is not a taxpayer for any UK tax purpose. Instead, a member of a partnership is taxed on the income and gains of the partnership either as an individual, a company or a trust – i.e. depending on the nature of the recipient. The opposite quality in an entity is (unsurprisingly) referred to as fiscally 'opaque'.

How is the question of entity classification approached?

As regards the classification of entities, the leading UK authority is the Court of Appeal decision in *Memec plc v IRC*.[6] The case concerned the classification for UK income tax purposes of a German silent partnership (stille Gesellschaft), between Memec plc and a German company, GmbH.

Gibson LJ delivered the leading judgment. He approached the issue by considering the characteristics of an ordinary English or Scottish partnership which make those entities transparent, and then comparing the extent to which those characteristics were shared (or not) by the entity in question.[7] The characteristics identified in *Memec* have since been adopted by HMRC, and are now listed in the guidance contained in the *International Tax Manual* (INTM) at 180010.

They are:

(a) whether the foreign entity has a legal existence separate from that of the persons who have an interest in it;

(b) whether the entity issues share capital or something else which serves the same function as share capital;

(c) whether the business is carried on by the entity itself or jointly by the persons who have an interest in it that is separate and distinct from the entity;

(d) whether the persons who have an interest in the entity are entitled to share in its profits as they arise; or whether the amount of profits to which they are entitled depends on a decision of the entity or its members, after the period in which the profits have arisen, to make a distribution of its profits;

(e) who is responsible for debts incurred as a result of the carrying on of the business: the entity or the persons who have an interest in it; and

(f) whether the assets used for carrying on the business belong beneficially to the entity or to the persons who have an interest in it.

HMRC also state that: ‘Some of the factors may point in one direction; others may point in another’, but ‘an overall conclusion is reached from looking at all the factors together, though some have more significance than others. Particular attention is paid to factors (c) and (d)’. In short, there will always be a measure of uncertainty as regards the classification of an entity where the factors identified point in different directions.

The uncertainty is to a degree mitigated by a list of foreign entities that appears at INTM 180030, together with HMRC’s view on how they are classified. However, the list is expressed to give only HMRC’s general view (INTM 180020). In a particular case regard may also need to be had to:

(a) the specific terms of the UK taxation provision under which the matter requires to be considered;

(b) the provisions of any legislation, articles of association, bylaws, agreement or other document governing the entity's creation, continued existence and management; and

(c) the terms of any relevant double taxation agreement.

The usefulness of HMRC's guidance is further qualified: in some instances HMRC's view was given many years ago, and there may have been significant changes in the relevant foreign law which may mean that a different conclusion as to the status of that entity might now be reached.

HMRC's guidance emphasises the fact that entities are described as fiscally 'transparent' or 'opaque' solely for the purposes of deciding how a member is to be taxed on the income they derive from their interest in the entity; the expressions are not interchangeable with 'partnership' or 'company' or 'body corporate'.

Before leaving the general discussion on the UK approach to entity classification, it is worth noting that, in *Memec*, it was not disputed that the source of the income of an individual partner in an English or Scottish partnership is the trading operations of the partnership.[8] Quite why that is so in the case of a Scottish partnership which has a separate legal personality has never (yet) satisfactorily been explained. Having identified the features of an English partnership, including a limited partnership, that enabled it to be treated as transparent, Gibson LJ ventured the following justification:[9]

> 'The justification for treating a Scottish partnership as transparent, though it may be less obvious because of the interposition of the partnership as a legal entity between the partners and the profits of the partnership, can be perceived in that *in substance, the position of the partners in relation to the profits is the same as in an English partnership*: those profits are earned by the partnership carrying on the business in common together and are shared in the same way and the partners, whilst not directly owning the business and assets, indirectly do so and have an

indirect interest in them which is capable of being arrested by the creditor of the partner.’ (emphasis supplied)

Therefore, the enquiry would appear to be into the ‘substance’ of a taxpayer’s legal relationship to the profits of the entity. The existence of a separate legal personality is not decisive. Further, equitable ownership of the profits as they arise is not the feature which makes an organisation fiscally transparent, because partners in a Scottish partnership do not have that kind of property in the profits. So there must be something else which makes an organisation transparent.

It has been suggested[10] that the ability of the members to remove their share of the profits from the organisation without there being any person who can restrict that ability is the single feature which makes an entity transparent for UK tax purposes. That view was tested and ultimately rejected by the Upper Tribunal and the Court of Appeal in *Anson*: a member’s automatic entitlement to profits, when not coupled with any proprietary interest in the profits of the business or the assets of the entity is not sufficient to make an entity transparent for UK tax purposes.

Anson – the facts

Mr. Anson was a member of HV, which during the relevant period managed various venture capital funds very profitably.

Under the relevant federal and state law, unless the members have elected otherwise, the profits of an LLC are treated as the profits of the members for fiscal purposes. Not having made the relevant election, HV was treated as ‘transparent’ in the USA. At the time when the profits of HV arose, Mr. Anson was resident but not domiciled in the UK, and he was liable to pay tax on income remitted to the UK which included his share of the profits of HV for the fiscal years 1998–2004, unless any double tax relief (DTR) or unilateral relief was available.

The question in issue fell to be determined by reference to Art 23(2)(a) of the UK–USA Double Tax Conventions of

1975 and of 2001. There was no material difference between the two conventions, and it was common ground that to obtain DTR, Mr. Anson had to establish that the share of HV's profits that he had remitted to the UK were the same as those by reference to which he was taxed in the USA. HMRC contended that Mr. Anson's share of HV's profits represented income received by him from his investment in HV and that these were not the same as the profits which HV made.[11]

The FTT had heard expert evidence on US law and had made detailed findings in relation to LLCs in general and HV in particular. The following features were considered by the Court of Appeal to be important:

(1) A LLC is an entity separate from its members; it holds its undertaking and assets separately from its members; and the principal characteristic of a Delaware LLC is that the statutory framework provides a number of default rules, which are subject to the parties' agreement.

(2) The statutory framework provides that:

- (a) profits and losses of the LLC are allocated to the members either as agreed in 'a LLC agreement' or in proportion to the agreed values of their contributions;
- (b) the LLC agreement can regulate members' voting rights, but in default the Delaware LLC Act specifies the voting rights of managing and non-managing members;
- (c) members have interests in the profits and assets of the LLC, which they can assign, but the LLC has no share capital;
- (d) members have capital accounts to which the LLC's profits are credited and losses debited. Members benefit rateably from any credit for tax purposes;
- (e) distribution and reserving policy is controlled by the 'managing members'. Accordingly managing members could determine the timing and amount of distributions out of members' capital accounts: members cannot compel the distribution of their capital accounts to themselves.

(3) The members of HV had entered into a LLC agreement dated 28 January 1997 on the following terms:
   (a) the members made initial capital contributions and agreed to make additional capital contributions when required by the managing members;
   (b) there was provision for the crediting to members' capital accounts of capital contributions and all gross income and capital gains, and for the debiting to such accounts of distributions and all losses and expenses;
   (c) there were complex provisions for determining the basis of allocation as between different members;
   (d) Art V dealt with distributions of net profits. This had four parts dealing with: distributions; set-off of sums due from members to HV; the creation of reserves, and the withholding of taxes. As regard distributions, the default position was that distributions of all of the excess of income and gains over losses, deductions and expenses allocated 'in accordance with Section 4.2 with respect to any calendar year will be made by the Company at such time within seventy-five (75) days following the end of such calendar year and in such amounts as the Managing Members may determine in their sole discretion. The Managing Members may from time to time in their discretion make additional distributions in accordance with the provisions of this article'. There were then provisions dealing with the order of priority of different types of distributions to members. The third part of Art V dealt with reserves. In effect, it enabled the LLC to withhold amounts which were otherwise distributable by the company to the members to make such provision as it thought desirable to meet liabilities, including future or contingent liabilities. The fourth part of Art V dealt with withholding tax: HV could retain out of profits the sums which it required to pay

withholding tax as a result of a member's status as a member or former member;

(e) Art XI dealt with dissolution and provided that surplus assets should be distributed to members in accordance with Art V.

Anson – the decision of the FTT [12]

The FTT found that the LLC was a separate legal entity, that its business was carried on by its members, that it owned its assets and that the members did not own its assets, that the LLC was liable for its debts, that the LLC did not have anything akin to share capital and that its capital was more like the partnership capital of an English partnership, and finally that the members of the LLC had an entitlement to profits as they arose. This latter finding became the central issue in this case.

The FTT's conclusion was expressed (at para 21) as follows: 'The factor we are mainly concerned with in relation to the Treaty is whether the profits belong to the members as they arise. We have concluded that this is the effect of the LLC … Agreement and the Act…'.

In essence, the FTT had considered that the members' arrangements for automatically allocating the profits to members meant that the profits of HV belonged to Mr. Anson throughout. As such, the decision of the only specialist tribunal that heard the case, was consistent with the view offered by practitioners (see above) i.e. that the feature which makes an entity transparent for UK tax purposes, is the ability of the members to remove profits from the organisation without there being any person who can restrict that ability.

The Upper Tribunal did not agree.

Anson – decision of the Upper Tribunal

Despite the attempts by counsel for Mr. Anson to persuade the Upper Tribunal that the FTT had not found that the members of HV had a *proprietary* entitlement to profits (and, broadly, that the findings of fact could not therefore be disturbed), the Upper Tribunal did not agree. It considered that the FTT had erred in law in holding that the members of HV had not merely a contractual but a proprietary entitlement to profits; and that the evidence did not support that conclusion.

Having addressed the question of the nature of the members’ entitlements afresh, it concluded (at para 55) that the profits of HV in respect of which, Mr. Anson was taxed in the USA:

> ‘were in law, reality and substance the profits of [HV] … it was a contractual entitlement to money, like the plc’s interest in the silent partnership in *Memec*… the profits were [HV’s] and the contractual obligation to credit and distribute did not make them the members’ at least for English tax purposes. The position of the members is nothing like the position of an English partner…’

Anson – in the Court of Appeal

The relevant test is whether the source is the same.

The Court of Appeal (Arden LJ giving the only judgment with which the others agreed) held that the relevant test for determining whether a person is taxed on the same profits, is whether the source is the same. This proposition is not controversial, but it is instructive to note that Arden LJ relied on the emphasis in the decision of Walker J (as he then was) in *Memec plc v IRC* in the High Court,[13] on the importance of the concept of the *source* of taxable profits in a schedular system of income tax. She considered that ‘source’ remains as important in a system where income tax is still imposed by reference to different categories of income.

The issue between the parties was how the source of Mr. Anson’s profits was to be determined.

Is the contract between the individual and the entity a separate source, or is it a mechanism to secure a right?

The answer generally turns on the existence of a proprietary interest in the profits of the entity.

As regards how the source of profits was to be determined, counsel for Mr. Anson submitted that:

(1) The same-source requirement is satisfied by showing that Mr. Anson's entitlement to profits was an automatic one, not dependent on the act of any third party.

(2) There is no requirement in the case-law or the revised HMRC guidance that there should be ownership of the assets of the business as well.

(3) There did not have to be a right to a profit; there had simply to be an entitlement to profits *as they arose*.

(4) In the case of HV, there was no intervening entitlement in HV as there would have been had there been a requirement for a directors' resolution to pay a dividend (which there was not). Accordingly, the requirement of entitlement was fulfilled.

For HMRC, it was argued that:

(1) A mere contractual right is not enough. There had to be a right to the profits, not merely a right to receive them as they arose.

(2) To be the same profits they must emanate from the same source and relate to the same period. The source in tax terms is the taxpayer's immediate source. A shareholder derives his dividend from his shares, and in that case the shares are the source, not the business of the company.

The Court of Appeal agreed with HMRC. It held as follows.

The presence of a contract generally suggests that there is a disposition of a right to the profits from one person to another. But that result can be avoided if a member has a proprietary right to the profits as they arise. This would generally be the case, for example, where income accrues under a trust under which an income beneficiary has an interest in possession, or to a unit trust or collective investment scheme, if the investors have a beneficial interest in the assets that are subject to the unit trust or scheme. Per Walker J in the High Court in *Memec*:

the income paid to a life tenant under an interest in a possession trust would be tax transparent *because the life tenant has an interest in the trust property*; and the decisive point was that Memec plc had no proprietary right in the shares of the subsidiaries of GmbH or to the distributions by them.

The question that the court is looking to answer is whether the member had a right to the profits when the profits were created, or as they accrued. In answering that question, the court will look at factors which throw light on the issue, such as those identified by the Court of Appeal in *Memec* (listed in HMRC's guidance referred to above).

Because profits do not arise until an account is struck for a particular period showing that there has been a profit, and because in general an entity will not have particular assets that can be said to be assets which represent the profit which it has made, in order for a member to show that he was entitled to profits from the moment that the profit arose, he will have to show that he has an interest in the assets to the value of the profit. This will necessarily be a proprietary interest. In so holding, Arden LJ derived assistance from the decision in *Memec* in the Court of Appeal, per Gibson LJ at p 765:

> 'even a Scottish partner has an (indirect) *interest in the profits of the partnership as they accrue* as well as in the assets of the partnership. In a real sense the profits and assets are the profits and assets of the partners, the firm, their collective alter ego, merely receiving those profits and holding those assets for the partners who are the firm. They are jointly and severally liable for the firm's debts…'

On the question of whether or not a contract has 'independent vitality,' or is 'mere machinery': it is not sufficient to find that there is a contract, if that contract is in reality simply the means whereby the entity transfers its right to receive or retain profits to the member. In that event, the contract will not be the source of the profit as from the moment of its creation.

But as regards the automatic allocation provisions of Art V of HV's LLC agreement, the Court of Appeal held that all that they achieved was to make it unnecessary to have a resolution of the managing members of HV before an allocation was made. Put another way, members had agreed in advance on those matters that were to prevent or limit a restriction on the distribution of profits. Accordingly, contrary to the conclusion of the FTT, the automatic allocation provisions did not affect the fact that the profits arose from the business of HV and were its profits. What the members obtained was a distribution out of its profits.

Permission to appeal in relation to an exchange of notes – refused

Permission to appeal on behalf of Mr. Anson was requested in relation to an exchange of notes dated 24 July 2001 between the government of the UK and the USA at the time of entry into force of the 2001 convention. The exchange of notes appears to clarify the right of a contracting state under Art 24 to levy tax 'with respect to' an item of income, profit or gain derived by a resident of that state (or citizen of the USA) from an entity that is fiscally transparent in either state. Mr. Anson's counsel sought to argue that that this wording meant it was unnecessary to show that tax was paid on the *same* profits in order to benefit from Art 24. The Court of Appeal refused the application because the issue had not been raised until after the Upper Tribunal had given its decision and there was some dispute about the mischief to which the exchange of notes was directed, and which it would require some evidence to resolve. Arden LJ considered that it would be surprising if an alteration to Art 23 had been dealt with in this oblique way.

CONCLUSION

The decision emphasises the need for US persons moving to the UK to consider restructuring their interests in LLCs before arrival. Equally, UK resident members of LLCs should consider postponing a distribution of profits until after they cease to be resident in the UK. This will mostly (but not only) affect people in private equity, hedge-fund managers, etc. The following additional remarks are offered by way of conclusion:

(1) The effect of the decision in *Anson* would appear to be that it is harder for entities with a separate legal personality to be transparent than was previously thought to be the case, a point not lost on counsel for Mr. Anson.

(2) In this regard, the following statement by Arden LJ’s at para [64] may be considered to be reassuring:

> ‘It would be unusual but not impossible for an entity with a separate legal personality, such as a company, to be tax transparent for English law purposes. One example would be the Scottish partnership where the partnership is a separate legal entity and holds the assets of the business, but the partners have an (indirect) interest in the assets and carry on business in common: this has been held by this court to be tax transparent and [counsel for HMRC] assured the court that nothing in his submissions was intended to undermine that position.’

(3) Although tax transparency for Scottish partnerships was preserved by the decision, no clear explanation was offered as to why members of a Scottish partnership were to be regarded as having an ‘indirect’ interest in any relevant sense in the assets of the partnership.

(4) It is as yet unclear whether the classification of any of the entities on HMRC’s list (at INTM 180030) will change, or whether HMRC will continue to regard all the factors identified in *Memec* as relevant. But Arden LJ did emphasise the relevance of those factors to the enquiry into whether a member has a right to the profits when they are created or when they accrue (at para [58]).

(5) Generally, given that the purpose of a double tax treaty is to eliminate double taxation, it is unclear why the question of entity classification should not be approached as a matter of 'substance':[14] to enable economic double taxation to be avoided, at least in certain cases.

(6) Instead, the emphasis on some sort of proprietary entitlement to the assets or profits of an entity raises very fine distinctions, which are not commercially relevant, and which require a detailed (and expensive) enquiry into the constitution of a foreign entity and the legal provisions it is subject to. The enquiry does not necessarily deliver a certain result.

(7) One possible solution to this problem would be to introduce an equivalent in the UK to the USA's 'check the box' rules; alternatively, for the courts to allow the tax treatment in the jurisdiction within which the entity is constituted to inform the question of the classification of an entity as transparent or opaque for UK tax purposes, at the very least where the taxpayers have elected for a particular treatment to apply.

(8) In the meantime, the decision of the Court of Appeal recognises that members of foreign entities, even of those with separate legal personalities, are able contractually to define their relationships with each other and with the entity in question, such as to secure transparency: creating automatic entitlement to profits, plus an interest in the assets of the entity and/or its profits would seem to be the way to do so.

It is not surprising that the exercise of shoehorning the characteristics of a foreign entity into the requirements of the UK tax code is a complex exercise. It is perhaps unsurprising that a close technical analysis appears here to have prevailed over economic substance. It remains to be seen what the Supreme Court will make of Mr. Anson's appeal[15] and which approach it will prefer.

Endnotes

1 Reprinted from the November Issue of The Journal of International Tax, Trust and Corporate Planning. © Jordan Publishing 2013 - Available in both print format and full archive online. Subscribe at www.jordanpublishing.co.uk

2 *Her Majesty's Revenue & Customs Commissioners v Anson* [2013] EWCA Civ 63, [2013] STC 557.

3 [2011] UKUT 318 (TCC), [2011] STC 2126.

4 Reported as *Swift v Her Majesty's Revenue & Customs Commissioners* [2010] UKFTT 88 (TC), [2011] SFTD 553.

5 The question of classification of entities as trusts is outside the scope of this article.

6 [1998] STC 754.

7 Ibid, at p 764.

8 Ibid, at p 762 referring to *Padmore v IRC* [1998] STC 493, at p 501.

9 Ibid, at p 764.

10 Inter alia by David Goldberg QC in an article for the Gray's Inn Tax Chambers Review.

11 HMRC did not seek to levy tax on Mr Anson on the basis that profits of HV could be attributed to him for tax assessment purposes. On the application of s 739 of the Income and Corporation Taxes Act 1988 to these facts, see Mann J's decision in *Anson* in the Upper Tribunal: [2012] UKUT 59 (TCC), [2012] STC 1014. That provision has now been re-acted as sections 720 to 727 of the Income Tax Act 2007.

12 See n 3, above, Avery-Jones and Menzies-Conacher.

13 [1996] STC 1336.

14 But note Mann J's remarks in the decision in the Upper Tribunal in relation to 'substance' at para 55. The relevant passage is quoted, above.

15 Mr. Anson's application for permission to appeal has been heard; permission to appeal to the Supreme Court was granted on 23 October 2013.